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IN THE

Supreme Court of the United States

October Term, 1941

No. 503.

PALM SPRINGS HOLDING CORPORATION,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

On Petition for Writ of Certiorari to the United States Circuit Court of Appeals for the Ninth Circuit.

BRIEF OF PETITIONER.

THOMAS R. DEMPSEY,
1104 Pacific Mutual Building, Los Angeles,
Attorney for Petitioner.

FRANK MERGENTHALER,
548 South Spring Street, Los Angeles,
Of Counsel for Petitioner.

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PALM SPRINGS HOLDING CORPORATION,

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BRIEF OF PETITIONER.

Opinions of the Courts Below.

The opinion of United States Board of Tax Appeals in this case is an unreported memorandum decision. [R. 30.] This decision was favorable to the petitioner with respect to depreciation upon buildings and favorable to the respondent with respect to depreciation on furniture and fixtures.

The judgment of the Circuit Court of Appeals for the Ninth Circuit is dated May 14, 1941, and is reported in 119 Fed. (2d) 846. [R. 88.] That decision was adverse to the petitioner.

Jurisdiction.

I.

The jurisdiction of this Court is invoked upon the grounds (1) that there is a conflict between the Circuit Court of Appeals for the Ninth Circuit and five other Circuits with respect to the questions here involved, and (2) that a question of law of wide importance in the administration of the Revenue Laws of the United States is in confusion and should be clarified.

II.

The jurisdiction of this Court is further invoked under Section 240(a) of the Judicial Code as amended by the Act of February 13, 1925, 43 Stat. 938, 28 U. S. C. A. Sec. 347(a); Rev. Stat. Sec. 1008 as amended (28 U. S. C. A. Sec. 350).

III.

The Supreme Court of the United States has heretofore granted a Writ of Certiorari herein directed to the United States Circuit Court of Appeals for the Ninth Circuit.

Statement of the Case.

A corporation known as the Palm Spring Hotel Co. owned a hotel. In July, 1932, the corporation had outstanding $309,000 of its first mortgage bonds which were a lien upon the hotel property. The hotel was leased to another company known as the El Mirador Hotel Operating Co., which owned the furniture and fixtures. To secure the performance of the terms of the lease, the El Mirador Hotel Operating Co. gave a chattel mortgage upon the said furniture and fixtures to the said Palm

Springs Hotel Co. This latter company in turn pledged the lease and chattel mortgage as part of the security for its said bond issue. [R. 23.]

In the spring of 1931 both the Palm Springs Hotel Co. and the El Mirador Hotel Operating Co. were in financial difficulties and were unable to meet their respective obligations, having sustained large operating deficits. [R. 24.] Under date of August 20, 1931, a bondholders protective committee for Palm Springs Hotel Co. first mortgage seven per cent s. f. gold bonds was formed to protect the interests of the holders of said bonds. [R. 25.] A copy of the bondholders' deposit agreement is set forth at pages 70 to 73 of the record.

The petitioner was formed under the laws of the State of California on April 1, 1932 [R. 22 and 25], pursuant to a plan of reorganization for the purpose of acquiring said bonds and ultimately all of the properties of said Palm Springs Hotel Co. and of the El Mirador Hotel Operating Co. During the month of May, 1932, the petitioner issued all of its preferred shares and part of its common shares in exchange for $292.000.00 par value of said bonds. [R. 26.] The remainder of its common shares were issued to R. D. Lacoe in consideration for his agreement to pay up to $1.000.00 the cost of incorporating the petitioner and for his agreement to lend moneys to the petitioner. Lacoe was also a holder of a large block of the bonds for which the other shares were issued. [R. 26 and 27.]

On or about July 15, 1932, petitioner was the successful bidder at a Trustee's sale of all of the properties of Palm Springs Hotel Co. held pursuant to the terms of

the indenture securing said bonds. The bid price was $61,800.00, which was paid as follows:

(a) Payment of cash amounting to	$18,767.96
(b) By the delivery to the Trustee of bonds of Palm Springs Hotel Co. having a face value of $292,000.00 for the balance of	43,032.04
	$61,800.00

The said properties were acquired subject to obligations prior to the lien of the bonds amounting to $38,949.76, of which amount $13,500.00 constituted a lien against furniture and fixtures. [R. 27 and 28.]

Among the assets acquired by the petitioner at the Trustee's sale were the said lease, the indebtedness thereon and the said chattel mortgage. [R. 27 and 28.]

On August 2, 1932, the taxpayer foreclosed on the chattel mortgage on the furniture and fixtures. [R. 28.] At the foreclosure sale the furniture and fixtures were sold to the taxpayer pursuant to a decree of foreclosure for a bid price of $20,179.25. [R. 28.] The amount of the judgment for the indebtedness of the El Mirador Hotel Operating Co. under the lease and chattel mortgage was $77,918.79. [R. 28.] The furniture and fixtures constituted all of the properties of the El Mirador Hotel Operating Co. [R. 27.]

The properties formerly owned by Palm Springs Hotel Co. and acquired by petitioner as aforesaid constituted what is known as the El Mirador Hotel at Palm Springs, California. [R. 23.]

All of the capital stock of Palm Springs Hotel Co. and El Mirador Hotel Operating Co., excepting in each case

ten (10) shares of capital stock owned by Warren B. Pinney, who was president of both companies, had been forfeited for nonpayment of assessments levied against the shares, so that at the time petitioner was organized said Pinney was the sole stockholder of both corporations. [R. 24 and 25.] Said Pinney received no capital stock of petitioner for his holding of capital stock of either of the two predecessor corporations; nor did any other stockholders of such corporations receive any shares of petitioner for any rights which they may have had as such stockholders. [R. 30.] Said Pinney received 1,000 shares of common stock of petitioner for his services in the reorganization and as an inducement to continue as manager of the Hotel. [R. 29.]

The petitioner on its Federal income tax return for the fiscal year ended May 31, 1936, deducted depreciation upon the hotel buildings and the furniture and fixtures and upon the bases of the two predecessor corporations. [R. 15.] The cost to Palm Springs Hotel Co., including all additions up to July 15, 1932, of the buildings which were acquired by petitioner as aforesaid was $686,731.97. Subsequently the petitioner, up to May 31, 1936, expended $82,652.81 for additions to said buildings. The useful life of the buildings was twenty years from January 1, 1928. [R. 29.]

The cost of El Mirador Hotel Operating Co., including all additions up to August 2, 1932, of the furniture and fixtures acquired by petitioner on the date named was $232,544.10. Subsequently petitioner acquired additional furniture and fixtures up to May 31, 1936, at a cost of $40,485.18. The useful life of said furniture and fixtures was twelve years from the date of acquisition new. [R. 29.]

Upon the examination of the return, the Commissioner of Internal Revenue disallowed the depreciation upon the basis mentioned and based his determination of deductible depreciation upon the said furniture and fixtures for income tax purposes upon what he claimed to be the fair market value thereof as of the date of foreclosure of the chattel mortgage. [R. 15.]

The amount of depreciation claimed by the petitioner upon the buildings was $51,955.72 based upon their cost to petitioner's predecessor corporation. [R. 13 and 15.] The amount of depreciation allowed by the Commissioner upon the buildings was $17,513.60 [R. 15] based on a valuation report as of date of acquisition, with the cost of improvements and additions added. [R. 13.]

The amount of depreciation claimed by the petitioner upon the furniture and fixtures was $32,083.57 based upon the cost of the same to the predecessor corporation. [R. 13 and 15.] The amount of depreciation allowed by the Commissioner upon the furniture and fixtures was $15,892.97 [R. 15] based on a valuation report as of date of acquisition, with the cost of improvements and additions added. [R. 13.]

The petitioner appealed to the United States Board of Tax Appeals from the Commissioner's determination. [R. 4.] The Board of Tax Appeals decided the issue of depreciation with respect to the buildings in favor of the petitioner, holding that the petitioner was entitled to use its predecessor's adjusted cost, and decided the issue of depreciation with respect to the furniture and fixtures in favor of the Commissioner of Internal Revenue, the respondent herein. [R. 33, 34 and 35.]

Both the petitioner and the respondent herein sought reviews of the decision of the United States Board of Tax Appeals. [R. 36 and 46.]

The Circuit Court of Appeals resolved both issues in favor of the Commissioner. [R. 95.]

The petitioner sought, and was granted, a writ of certiorari herein to review the decision of the United States Circuit Court of Appeals for the Ninth Circuit.

Specification of Assigned Errors to Be Urged.

1. The Circuit Court of Appeals for the Ninth Circuit erred in refusing to hold that the steps taken by the petitioner in acquiring the assets of the Palm Springs Hotel Co. and the El Mirador Hotel Operating Co. constituted a tax free reorganization whereby the petitioner as a party to the reorganization is entitled to the same basis for depreciation as the predecessor insolvent corporations.

2. The Circuit Court of Appeals for the Ninth Circuit erred in refusing to hold that this case is governed by the cases of *Commissioner v. Newberry L. & C. Co.*, 94 Fed. (2d) 447 (C. C. A. 6th); *Commissioner v. Kitselman*, 89 Fed. (2d) 458 (C. C. A. 7th); *Commissioner v. Southwest Consolidated Corporation*, 119 Fed. (2d) 561 (C. C. A. 5th), and *Commissioner v. Alabama Asphaltic Limestone Company, Inc.*, 119 Fed. (2d) 819 (C. C. A. 5th).

3. The Circuit Court of Appeals for the Ninth Circuit erred in holding that the cases of *LeTulle v. Scofield*, 308 U. S. 415, and *Helvering v. Tyng*, 308 U. S. 527, overruled the cases of *Newberry* and *Kitselman*, *supra*.

4. The Circuit Court of Appeals for the Ninth Circuit erred in rejecting the petitioner's contention that immediately after the above mentioned transfer an interest or control in the transferred property of 50 per centum or more remained in the same persons as before the transfer.

5. The Circuit Court of Appeals for the Ninth Circuit erred in holding that prior to the transfer the taxpayer had no interest or control in any of the property but was merely a creditor of the Hotel Company and the Operating Company.

6. The Circuit Court of Appeals for the Ninth Circuit erred in holding that the basis of the petitioner for the real and personal property was the cost thereof to the petitioner.

Questions Presented.

1. DID THE PETITIONER ACQUIRE ITS HOTEL BUILDING IN CONNECTION WITH A TAX FREE REORGANIZATION WHICH ENTITLES IT TO USE THE ADJUSTED BASIS OF ITS PREDECESSOR CORPORATION PLUS ADDITIONS FOR THE PURPOSE OF COMPUTING DEDUCTIBLE DEPRECIATION FOR INCOME TAX PURPOSES?

2. DID THE PETITIONER ACQUIRE THE HOTEL FURNITURE AND FIXTURES IN CONNECTION WITH A TAX FREE REORGANIZATION WHICH ENTITLES IT TO USE THE ADJUSTED BASIS OF ITS PREDECESSOR CORPORATION PLUS ADDITIONS FOR THE PURPOSE OF COMPUTING DEDUCTIBLE DEPRECIATION FOR INCOME TAX PURPOSES?

Summary of Argument.

The Palm Springs Hotel Co. and the El Mirador Hotel Operating Co. in 1932 were insolvent. The petitioner was the owner of approximately 95% of the outstanding bonds of the Palm Springs Hotel Co. which were a lien upon all of the property of the Palm Springs Hotel Co. By virtue of a trustee's sale under the bond issue, the petitioner acquired the chattel mortgage, lease and indebtedness of the El Mirador Hotel Operating Co. Owing to the insolvency of these two companies and the superior position of the petitioner as a holder of the bonds and chattel mortgage the petitioner was, to all practical effects and purposes, a stockholder of the two companies, owning an interest or control in excess of 95% of the assets in both companies because of the disappearance of the equities of the stockholders in the two predecessor corporations. Since the petitioner ultimately acquired all of the assets of the two companies by the issuance of its stock and the petitioner's stockholders were the virtual stockholders of the two predecessor companies, the steps by which it acquired all of the assets of the two old companies constituted a tax free reorganization and consequently petitioner is entitled to use the adjusted basis of the two old companies for the purpose of computing depreciation for income tax purposes.

Argument.

The question involved in this proceeding is the proper basis for computing depreciation upon the buildings, furniture and fixtures of the petitioner for income tax purposes for the fiscal year ended May 31, 1936. The petitioner contends that it has the right to compute its depreciation upon the adjusted basis of its predecessor corporations plus cost of additions. The respondent, on the other hand, contends that the petitioner is entitled to deduct depreciation upon the fair value of the assets as of date of acquisition by the petitioner plus cost of additions.

The petitioner held $292,000.00 par value out of $309,000.00 par value of the outstanding first mortgage bonds of the Palm Springs Hotel Co. [R. 23 and 26.] This was approximately 95% of the entire issue. These bonds were secured by an indenture which was a lien upon all of the assets of the obligor. [R. 23.] The Palm Springs Hotel Co. had leased the building to the El Mirador Hotel Operating Co., which latter company was the lessee of the hotel building. [R. 23.] The latter company gave to the Palm Springs Hotel Co. a chattel mortgage on its furniture and fixtures to secure the performance of the terms of the lease. [R. 23.] The Palm Springs Hotel Co. in turn pledged this lease and chattel mortgage as additional security under the indenture securing the bonds. [R. 23.] The Palm Springs Hotel Co. and the El Mirador Hotel Operating Co. were insolvent in 1932 [R. 24], at which time the petitioner was the owner of approximately 95% of the outstanding bonds. All except ten shares of the stock of each of the Palm Springs Hotel Co. and the El Mirador Hotel Operating Co. had been sold for assessments and each company.

bought in all of its respective shares except ten shares in each company which were retained by W. B. Pinney, who then became the sole stockholder in each of the two old companies. [R. 24 and 25.] This sole stockholder became a stockholder of the petitioner. [R. 29.]

In 1932 the trustee under the trust indenture sold all of the properties of the Palm Springs Hotel Co. including the chattel mortgage and lease to the petitioner who bid $61,800.00 for the said assets. This bid was paid as follows:

Cash	$18,767.96
Bonds of Palm Springs Hotel Co. of the par value of $292,000	43,032.04
	$61,800.00 [R. 27.]

Thereafter the petitioner foreclosed the chattel mortgage given by the El Mirador Hotel Operating Co. in a court proceeding in which the petitioner procured a judgment of $77,918.79 on the said lease. The furniture and fixtures of the El Mirador Hotel Operating Co. were sold to the petitioner under said judgment for $20,179.25. These furniture and fixtures constituted all of the assets of the El Mirador Hotel Operating Co. [R. 28.]

All of said assets were acquired by the petitioner pursuant to a Plan of Reorganization which is set forth in a copy of the Bondholders' Protective Agreement. [R. 70-73 incl. and 78-81 incl.]

The petitioner was entitled to deduct upon its Federal income tax return for its fiscal year ended May 31, 1936, depreciation upon its properties for income tax purposes. This deduction is provided for by Section 23 of the

Revenue Act of 1934. [See Appendix for Statutes.] The controversy here arises over the basis to be used for that purpose. The petitioner claims the right to use the adjusted basis of the two old corporations whereas the Commissioner contends that the basis should be the fair market value as of the date of foreclosure. [R. 15.]

The Circuit Court Erred in Refusing to Hold That the Steps by Which the Petitioner Acquired All the Property of the Two Old Corporations Constituted a Tax Free Reorganization Which Entitles the Petitioner to Use the Adjusted Bases of the Old Companies in Computing Its Depreciation for Income Tax Purposes.

Under Section 113 of the Revenue Act of 1934 [see Appendix] the cost of property is the normal basis for computing depreciation. There are exceptions to this rule and it is the contention of the petitioner that the Circuit Court failed to follow a long line of decisions holding that similar transactions resulted in tax free reorganizations which give rise to one of the exceptions mentioned. Reference to Sections 114 (a) and 113 (a) (12) and 113 (b) of the Revenue Act of 1934 will disclose that the provisions of Section 112 (a) and (b), Section 113 (a) (7), and Section 114 (a) of the Revenue Act of 1932 govern the basis upon which the petitioner claims the right to compute depreciation for income tax purposes. [See Appendix.]

Section 113 (a) (7) of the Revenue Act of 1932, in effect, provides that if property was acquired after December 31, 1917, by a corporation in connection with a reorganization and immediately after the transfer of an interest or control of such property of 50% or more

remained in the same persons or any of them the basis for depreciation shall be the same as it would be in the hands of the transferor, with certain adjustments.

Section 112 (i) of the same Act defines the term "reorganization" as, among other things: (A) a merger or consolidation (including the acquisition by one corporation of at least a majority of the voting stock and at least a majority of the total number of shares of all other classes of stock of another corporation, or substantially all the properties of another corporation), or (B) a transfer by a corporation of all or a part of its assets to another corporation if immediately after the transfer the transferor or its stockholders or both are in control of the corporation to which the assets are transferred.

This section defines further the term "a party to a reorganization" as to include both corporations in the case of an acquisition by one corporation of at least a majority of the voting stock and at least a majority of the total number of shares of all other classes of stock of another corporation.

Subsection (j) of the same section defines the word "control" as meaning at least 80 per centum of the voting stock and at least 80 per centum of the total number of shares of all other classes of stock of the corporation.

The petitioner's application for a Writ of Certiorari was grounded upon the fact that a number of cases in which the factual situations are very similar to the one at bar have been passed upon in the Circuit Courts of Appeals in at least six Circuits. With the exception of the Ninth Circuit, all of the Circuits in which the cases have arisen have held that a tax free reorganization resulted where bondholders foreclosed a bond issue and

formed a new corporation to which the property of the obligor was transferred and the bondholders of the old company were the controlling stockholders of the new corporation. The leading case upon the subject is the case of *Commissioner v. Kitselman*, 89 Fed. (2d) 458 (C. C. A. 7th) (certiorari denied 302 U. S. 709). This case was followed in the case of *Commissioner v. Newberry L. & C. Co.*, 94 Fed. (2d) 447 (C. C. A. 6th). The Circuit Court of Appeals for the Second, Fifth, Sixth, Seventh and Tenth Circuits have all determined the question in favor of the taxpayers. In addition to the *Kitselman* and *Newberry* cases the following is a list of the cases so determined in the various taxpayers' favor:

Commissioner v. Southwest Consolidated Corporation, 119 Fed. (2d) 561 (C. C. A. 5th), decided April 19, 1941; certiorari granted October 13, 1941;

Commissioner v. Alabama Asphaltic Limestone Company, 119 Fed. (2d) 818 (C. C. A. 5th), decided May 5, 1941; certiorari granted October 13, 1941;

Commissioner v. New Haven and Shore Line Railway Company, Inc., ... Fed. (2d) ..... (C. C. A. (2d), decided July 16th, 1941; reported in Prentice-Hall, 1941 Fed. Tax Service, par. 62,841;

Commissioner v. James Q. Newton Trust, ... Fed. (2d) ..... (C. C. A. 10th), decided July 24th, 1941.

The Circuit Court of Appeals for the Ninth Circuit struck the first discordant note when it decided the cases of *Commissioner of Internal Revenue v. Bondholders Committee, et al.*, and *Commissioner of Internal Revenue v. Marlborough House, Inc.*, 118 Fed. (2d) 511, wherein

the Court held that the opinion of the Supreme Court of the United States in the *LeTulle* case contained language broad enough to overrule the *Kitselman* and *Newberry* cases, and decided the cases against the taxpayers. Then followed the opinion of the Ninth Circuit in the instant case of *Commissioner v. Palm Springs Holding Corporation*, 119 Fed. (2d) 846, in which it was held that the *Kitselman* and *Newberry* cases were overruled by the *LeTulle* and *Tyng* cases.

In the case of *Commissioner v. New Haven & Shore Line R. R. Co.*, *supra*, the Court said:

> "The crux of the case at bar is therefore whether, since the seller was definitely insolvent—that is to say, since its shares could not possibly have any value—the bondholders were to be regarded as surrendering the same interest that they got back in the form of shares in the buyer. Did the seller's insolvency provide the required 'continuity of interest'? That question has come up five times, under the Act of 1928 or the Act of 1934, either as a question of 'recognizable' gain or loss, or of depreciation. Three circuit courts of appeal have held that there was a 'reorganization'—one of them since LeTulle v. Scofield, *supra* (308 U. S. 415) was decided. Commissioner v. Kitselman, 89 F. (2d) 458 (C. C. A. 7); Commissioner v. Newberry L. & C. Co., 94 F. (2d) 447 (C. C. A. 6); Commissioner v. Southwest Consolidated Corp., 119 F. (2d) 561 (C. C. A. 5), and Commissioner v. Alabama Asphaltic Co., 119 F. (2d) 819 (C. C. A. 5). The Ninth Circuit has, however, held otherwise. Commissioner v. Marlborough House, Inc., 118 F. (2d) 511. It seems to us that the majority has been right. Certainly LeTulle v. Scofield, *supra* (308 U. S. 415), had no such question in mind,

in spite of its including Commissioner v. Kitselman in the note on page 420; it very explicitly put the decision on the fact that creditors, no matter how distant might be the maturity of their debts, had no interest in the debtor's property, even though they were secured by a lien."

It is submitted that the divergence between the Ninth Circuit and the other Circuits hereinbefore mentioned could only arise because of the misconstruction of the *LeTulle* and *Tyng* cases, *supra*, by the Circuit Court of Appeals for the Ninth Circuit.

In both the *LeTulle* and *Tyng* cases, stockholders of the transferor corporations received stocks, bonds and cash of the transferee corporations and thus were converted from stockholders of the transferor corporations into creditors of the transferee corporations. No insolvent corporations were involved, consequently, there was no continuity of interest in the assets of the transferors remaining in the hands of LeTulle and Tyng. In the instant case the two old corporations were insolvent as a consequence of which the bondholders were moved up to the status of stockholders and had approximately 95% interest and control in the assets of the two old companies. They received stock in the transferee corporation for their securities in the old corporations and they retained an interest or control of over 50% in the assets. Therefore, there exists here a continuity of interest that is lacking in the *LeTulle* and *Tyng* cases. This distinction was pointed out by the Board of Tax Appeals in the case of *Commissioner v. James Q. Newton*, 42 B. T. A. 473, at 483, in which the facts are comparable to those in the case at bar. The *Newton* case has been affirmed by the Circuit Court of Appeals for the Tenth Circuit.

The LeTulle Case Does Not Overrule the Kitselman Case.

The contention of the respondent before the Circuit Court of Appeals was that the *LeTulle* case overruled the *Kitselman* case by implication. As hereinbefore pointed out, in the *LeTulle* case the stockholder of the transferor company received bonds of the transferee corporation and therefore became a creditor in the new company, whereas he was a stockholder in the old company. In the instant case the bondholders of an insolvent corporation, having a control or interest in the assets of the old company, exchanged their bonds for stock in the transferee corporation, thus maintaining the continuity of interest, which was lacking in the *LeTulle* case. In the *LeTulle* case the Court said:

> "Where the consideration is wholly in the transferee's bonds, or part cash and part such bonds, we think it cannot be said that the transferor retains any proprietary interest in the enterprise. On the contrary, he becomes a creditor of the transferee; and we do not think that the fact referred to by the Circuit Court of Appeals, that the bonds were secured solely by the assets transferred and that upon default, the bondholder would retake only the property sold, changes his status from that of a creditor to one having a proprietary stake, within the purview of the statute."

Certainly the Second, Fifth and Tenth Circuits, as hereinbefore pointed out, have held that the *Kitselman* case is not overruled by the *LeTulle* case. It will be noted that the Supreme Court of the United States in footnote

7 to the *LeTulle* opinion cited the *Kitselman* case as an example of the difficulty in classifying securities. It would seem somewhat strange that the Court would cite the *Kitselman* case in a footnote to the *LeTulle* case if it had intended to overrule it. If anything it would appear that such a citation would rather imply an approval of the case.

Randolph E. Paul in his *Studies in Federal Taxation*, Third Series, at page 160, says:

> "There would seem to be no reason for interpreting the LeTulle case as casting doubt upon the Kitselman doctrine. The LeTulle case merely decides that bondholders in a solvent corporation, since they are not the equity proprietors, cannot be the conduit for the requisite continuing interest. But the all-important fact of the insolvency of the old corporation, causing the bondholders to replace the shareholders as owners of the proprietary interest, was wholly absent in the LeTulle case. Where, on the other hand, the bondholders step into the shoes of the stockholders by reason of insolvency, and acquire stock in the new company in exchange for their interest in the old, no collision with the LeTulle principle is present."

Analyses of the *LeTulle* decision are presented in C. C. H. Illustrative Bulletin E, May 8, 1940; The Meaning of *LeTulle v. Scofield, Silverson*, 18 Tax Magazine, 492 (1940), Income Tax Problems of Reorganization, Virgil S. Chandler, December 1940, University of Kansas City Law Review, Volume IX, page 22.

Congress Has Not Repudiated the Doctrine of the Kitselman Case.

The *Kitselman* case was decided April 12, 1937, by the United States Circuit Court of Appeals for the Seventh Circuit and, with the exception of the Ninth Circuit Court of Appeals, it has been followed consistently by other circuits and by the United States Board of Tax Appeals in cases involving the same issues. Since the decision of the *Kitselman* case Congress has adopted several Revenue Acts, to-wit: The Acts of 1938, 1939, 1940 and 1941, but in none of these Acts has Congress repudiated the doctrine of the *Kitselman* case.

The *Kitselman* case is not an obscure authority. On the contrary it has been the subject of much discussion in the field of tax law and it can scarcely be contended that it has escaped the notice of Congress. It would seem reasonable to suppose that since Congress has taken no legislative action to overcome the effect of the case, taxpayers are entitled to assume that Congress approves the *Kitselman* doctrine. Even prior to the decision of the *Kitselman* case, Congress appears to have approved of the principle as will appear from the Ways and Means Committee report of the House of Representatives published in CB 1939-1 Part 2, pages 564 and 565, extracts of which are set forth in the Appendix hereto, and as further appears from the report of the Senate Committee on Finance published in CB 1939-1 Part 2, pages 598 and 599, also set forth in the Appendix hereto.

The Respondent Herein Has Adopted a Totally Inconsistent Position With That Maintained by Him in the Case of Commissioner v. Kitselman.

In the *Kitselman* case (*supra*) a bondholder of a corporation sought to deduct a loss upon the exchange of his bonds in the corporation for stock of another corporation which was formed for the purpose of acquiring the old corporation's assets at a foreclosure on the bond issue. In that case the Commissioner vigorously and successfully maintained that the bondholder was not entitled to a deduction for the reason that the exchange of the bonds of the old company for the stock of the new company was in connection with a tax free reorganization and under the appropriate provisions of the Revenue law no loss could be recognized. The taxpayer sought a Writ of Certiorari, which was denied by your Honorable Court, 302 U. S. 709. The petitioner is informed that in the Commissioner's brief filed on November 2, 1936, in the Seventh Circuit Court, case No. 6022, *Commissioner v. Kitselman*, the Commissioner argued at page 17 of the brief as follows:

> "Under these decisions, it is submitted, for reorganization purposes, a bondholder stands in no different position from a stockholder with respect to an interest in the assets and affairs of a corporation and where, as in the present case, the bondholders were the only parties in interest in the assets of an insolvent corporation, a continuity of their (the bondholders) interest in the assets in the hands of a new corporation is a sufficient compliance with the requirements of the statute. That these bondholders were the only real parties in interest will be realized when it is observed that upon the foreclosure sale all the properties of the old corporation brought only

'$430,000 free and clear of all liens and encumbrances, except the lien of any taxes, assessments, and water rents lawfully levied or assessed, and also the lien of the first mortgage securing the I. Rv. Co. bonds not in default' [R. 32-33], and that the defaulting bond issues under which these assets were sold amounted to the total sum of $3,989,000 [R. 31]."

And at page 18:

"It is also plain, we submit, that merely because one of the steps in the plan of reorganization as formulated and executed consisted of foreclosure proceedings and a judicial sale of the mortgaged assets prior to transfer to a new corporation formed for that purpose, such procedure will not defeat what may otherwise be regarded as a statutory reorganization. It will also be observed that this procedure was taken 'at the instigation of the committee, in pursuance of the plan and agreement' [R. 32]. It has long been established that acquisition of assets through the medium of foreclosure proceedings does not of itself take the transfer out of reorganization provisions."

There Was Continuity of Interest and Control in the Petitioner in the Assets of the Two Old Corporations.

Under the provisions of Section 113 (a) (7), if property was acquired after December 31, 1917, by a corporation in connection with a reorganization and immediately after the transfer of an interest or control of such property of 50% or more remained in the same persons or any of them the basis for depreciation is the same as it would be in the hands of the transferor, with certain adjustments not here applicable. [See Appendix. Section 112 (i) (1) (2) (j) defines the term "reorganization."]

In the present case the issue boils down to whether or not the petitioner was the owner, prior to the foreclosure, of an interest or control in the assets of the Palm Springs Hotel Co. and El Mirador Hotel Operating Co. Upon this point it is significant to note that before the Trustee's sale under the bond issue the stockholders of both companies, with the exception of Warren B. Pinney who held 10 shares in each company, had lost their stock in both companies by virtue of nonpayment of assessments against the stock. [R. 25.] At the time of the sale under the trust indenture, to-wit, May 21, 1932 [R. 27], the stockholders of the two old companies were utterly without a voice as to what should be done with the properties of the two old corporations. They had lost their interest or equity in the assets by virtue of the insolvency of the companies. At that time the only interest or control in the assets of both companies resided in the bondholders of the Palm Springs Hotel Co. The petitioner was then the owner of aproximately 95% of those bonds. [R. 23 and 26.] Among the assets pledged to secure that bond issue were the lease and chattel mortgage of the El Mirador Hotel Operating Co., which was heavily indebted under the terms of the lease. The stockholders of the El Mirador Hotel Operating Co. had no more to say about the furniture and fixtures than those at the Palm Springs Hotel Co. had to say about its buildings. The only interest and control in those assets that existed were vested in the petitioner by reason of its ownership of the bonds of Palm Springs Hotel Co. Without any interference on

the part of either of the two old corporations the petitioner proceeded to take over the assets of both corporations by virtue of the bond issue.

It would ignore the legal and practical aspects of the situation to say that the stockholders of the two old corporations retained the slightest interest in the assets. At the time of the sale the petitioner was the only one who had any interest or control in those assets and since it acquired all of the assets of both old corporations it would clearly appear that under Section 112 (i) (1) and (2) of the Revenue Act of 1932 a tax free reorganization was consummated and that the basis for depreciation must be sought for in the provisions of Sections 113 (a) (7) and 114 (a) of the Act of 1932. These sections are set out in the Appendix.

They provide, in effect, that the basis for depreciation in the case of a tax free reorganization shall be the same as that of the transferor with certain adjustments not here applicable.

Since the petitioner contends that it acquired the assets of the two predecessor corporations in a tax free reorganization, it follows that it is entitled to use these adjusted bases in determining the amount of depreciation on these assets for the purpose of computing the petitioner's income tax.

In Principle There Should Be No Distinction Drawn Between the Buildings and the Furniture and Fixtures in so Far as Deductible Depreciation Is Concerned.

As hereinbefore pointed out the Board of Tax Appeals on the strength of the cases of *Commissioner v. Kitselman* and *Commissioner v. Newberry L. & C. Co.* (*supra*) has held that the petitioner was entitled to deduct depreciation on the hotel buildings on the adjusted basis of the Palm Springs Hotel Co., whereas with respect to depreciation on the furniture and fixtures it could deduct depreciation based on cost to the petitioner. The rights of the petitioner in respect to the buildings and the furniture and fixtures were derived by virtue of its ownership of the bonds of the Palm Springs Hotel Co. These bonds were secured by an indenture covering all of the assets of the Palm Springs Hotel Co. [R. 23 and 27.] Among those assets was the lease of the hotel to El Mirador Hotel Operating Co. This lease was secured by a chattel mortgage on the furniture and fixtures [R. 23] and this chattel mortgage was part of the assets which were secured by the indenture of the Palm Springs Hotel Co. [R. 23.] By virtue of the indebtedness of the El Mirador Hotel Operating Co. under the terms of the lease to the Palm Springs Hotel Co., which in turn was virtually owned or controlled by the petitioner herein, by reason of its ownership of the bonds of Palm Springs Hotel Co., the petitioner was virtually the owner of the entire interest and control of the furniture and fixtures in question. It is true that it was one step removed from those items of personal property, but it was the only one who had any control over them, and having acquired the lease and chattel mortgage at the Trustee's sale on the bond issue [R.

27] it proceeded to foreclose the chattel mortgage in a court action and acquired those assets. [R. 28.] As far as practical effects were concerned the Palm Springs Hotel Co. itself might just as well have been the owner of the furniture and fixtures. Consequently, it is the contention of the petitioner that no distinction should be made between the buildings and the furniture and fixtures in so far as the basis for the computation of depreciation is concerned for income tax purposes.

Conclusion.

It is respectfully submitted that the petitioner acquired the assets of the two old corporations in a tax free reorganization which entitled it to use the adjusted basis of the old corporations in computing depreciation for the purpose of income tax and that the Ninth Circuit Court of Appeals was in error in holding that the *LeTulle* case overruled the *Kitselman* case and in giving judgment against the petitioner.

It is further respectfully submitted that the judgment of the Circuit Court of Appeals should be reversed.

THOMAS R. DEMPSEY,
1104 Pacific Mutual Building, Los Angeles, California,
Attorney for Petitioner.

FRANK MERGENTHALER,
548 South Spring Street, Los Angeles, California,
Of Counsel for Petitioner.

APPENDIX.

Sections of the 1936 Revenue Act, 26 U. S. C. A.

Internal Revenue Acts:

SEC. 1. APPLICATION OF TITLE.

The provisions of this title shall apply only to taxable years beginning after December 31, 1935. Income, war-profits, and excess-profits taxes for taxable years beginning prior to January 1, 1936, shall not be affected by the provisions of this title, but shall remain subject to the applicable provisions of prior Revenue Acts, except as such provisions are modified by legislation enacted subsequent to this Act. (p. 819.)

Sections of the 1934 Revenue Act, 26 U. S. C. A., Internal Revenue Acts:

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

(1) Depreciation.—A reasonable allowance for the exhaustion, wear and tear of property used in the trade or business, including a reasonable allowance for obsolescence. * * * (p. 673.)

SEC. 114. BASIS FOR DEPRECIATION AND DEPLETION.

(a) BASIS FOR DEPRECIATION.—The basis upon which exhaustion, wear and tear, and obsolescence are to be allowed in respect of any property shall be the adjusted basis provided in section 113 (b) for the purpose of determining the gain upon the sale or other disposition of such property. (p. 701.)

SEC. 113. ADJUSTED BASIS FOR DETERMINING GAIN OR LOSS.

(b) ADJUSTED BASIS.—The adjusted basis for determining the gain or loss from the sale or other disposition of property, whenever acquired, shall be the basis determined under subsection (a), adjusted as hereinafter provided. (p. 700.)

SEC. 113. ADJUSTED BASIS FOR DETERMINING GAIN OR LOSS.

(a) Basis (Unadjusted) of Property. The basis of property shall be the cost of such property; except that—

(12) BASIS ESTABLISHED BY REVENUE ACT OF 1932.—If the property was acquired after February 28, 1913, in any taxable year beginning prior to January 1, 1934, and the basis thereof for the purpose of the Revenue Act of 1932 was prescribed by section 113 (a) (6), (7), or (9) of such Act, then for the purposes of this Act the basis shall be the same as the basis therein prescribed in the Revenue Act of 1932. (p. 700.)

Sections of the 1932 Revenue Act, 26 U. S. C. A., Internal Revenue Acts:

§114. BASIS FOR DEPRECIATION AND DEPLETION.

(a) Basis for Depreciation. The basis upon which exhaustion, wear and tear, and obsolescence are to be allowed in respect of any property shall be the adjusted basis provided in section 113 (b) for the purpose of determining the gain or loss upon the sale or other disposition of such property. (p. 519.)

§113 ADJUSTED BASIS FOR DETERMINING GAIN OR LOSS.

(b) Adjusted Basis. The adjusted basis for determining the gain or loss from the sale or other disposition of property, whenever acquired, shall be the basis determined under subsection (a), adjusted as hereinafter provided. (p. 518.)

§113 ADJUSTED BASIS FOR DETERMINING GAIN OR LOSS.

(a) Basis (Unadjusted) of Property. The basis of property shall be the cost of such property; except that—

(7) Transfers to corporation where control of property remains in same persons. If the property was acquired after December 31, 1917, by a corporation in connection with a reorganization, and immediately after the transfer an interest or control in such property of 50 per centum or more remained in the same persons or any of them then the basis shall be the same as it would be in the hands of the transferor, increased in the amount of gain or decreased in the amount of loss recognized to the transferor upon such transfer under the law applicable to the year in which the transfer was made. This paragraph shall not apply if the property acquired consists of stock or securities in a corporation a party to the reorganization, unless acquired by the issuance of stock or securities of the transferee as the consideration in whole or in part for the transfer. (p. 516.)

§112 RECOGNITION OF GAIN OR LOSS.

(a) General Rule. Upon the sale or exchange of property the entire amount of the gain or loss, determined under section 111, shall be recognized, except as hereinafter provided in this section.

(b) Exchanges Solely in Kind—

* * * (3) Stock for stock on reorganization. No gain or loss shall be recognized if stock or securities in a corporation a party to a reorganization are, in pursuance of the plan of reorganization, exchanged solely for stock or securities in such corporation or in another corporation a party to the reorganization.

(4) Same—Gain of corporation. No gain or loss shall be recognized if a corporation a party to a reorganization exchanges property, in pursuance of the plan of reorganization, solely for stock or securities in another corporation a party to the reorganization.

(5) Transfer to corporation controlled by transferor. No gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock or securities in such corporation, and immediately after the exchange such person or persons are in control of the corporation; but in the case of an exchange by two or more persons this paragraph shall apply only if the amount of the stock and securities received by each is substantially in proportion to his interest in the property prior to the exchange. (p. 511.)

* * * * * * * * *

(i) Definition of Reorganization. As used in this section and sections 113 and 115—

(1) The term "reorganization" means (A) a merger or consolidation (including the acquisition by one corporation of at least a majority of the voting stock and at least a majority of the total number of shares of all other classes of stock of another corporation, or substantially all the properties of another corporation), or (B) a transfer

by a corporation of all or a part of its assets to another corporation if immediately after the transfer the transferor or its stockholders or both are in control of the corporation to which the assets are transferred, or (C) a recapitalization, or (D) a mere change in identity, form, or place or organization, however effected.

(2) The term "a party to a reorganization" includes a corporation resulting from a reorganization and includes both corporations in the case of an acquisition by one corporation of at least a majority of the voting stock and at least a majority of the total number of shares of all other classes of stock of another corporation. (pp. 513, 514.)

(j) Definition of Control.—As used in this section the term "control" means the ownership of at least 80 per centum of the voting stock and at least 80 per centum of the total number of shares of all other classes of stock of the corporation.

COMMITTEE REPORTS.

The Ways and Means Committee (Report published in C. B. 1939—1, Part 2, pp. 564, 565), after stating astute lawyers had taken advantage of the reorganization provisions by "arranging in the technical form of reorganization, within the statutory definition, what were really sales," said:

"By these limitations the committee believes that it has removed the danger that taxable sales can be cast into the form of a reorganization, while at the same time, legitimate reorganizations, required in order to strengthen the financial condition of the corporation, will be permitted. Furthermore, the retention of the reorganization

provisions will prevent large losses from being established by bondholders and stockholders who receive securities in a newly reorganized enterprise which are substantially the same as their original investments. * * * Likewise, many corporations have defaulted upon the dividends on their cumulative preferred stock, or upon the interest on their bonds. *These corporations,* in order to obtain necessary credit from the banks, *are arranging with* their preferred stockholders to accept new common stock and with *their bondholders to accept noncumulative preferred* stock or *bonds now held.* If the reorganization provisions were omitted from the bill, these stockholders *and bondholders* could take large losses, *although they still retain an interest in the corporation.* Although the losses in the cases given would be subject to the new limitations the committee has placed upon the deduction of capital losses, the net result, during the next year or more, of omitting the reorganization provisions might be a loss of taxes to the Treasury. The Committee, therefore, has decided that the reorganization provisions should be retained, but with restrictions to make tax avoidance impossible." (Italics supplied.)

The Senate Finance Committee said (C. B. 1939—1, Part 2, at pp. 598, 599):

"In the second place, the House bill eliminates from the definition of 'reorganization' as it appears in the present law the parenthetical phrase appearing after the words 'merger or consolidation,' which reads as follows: '(including the acquisition by one corporation of at least a majority of the voting stock and at least a majority of the total number of shares of all other classes of stock of another corporation, or substantially all the properties of another corporation).'

The House report states:

"'In the second place, the definition of a reorganization has been restricted so that the definition will conform more closely to the general requirements of corporation law, and will limit reorganizations to (1) statutory mergers and consolidations; (2) transfers to a controlled corporation, 'control' being defined as an 80 per cent ownership; and (3) changes in the capital structure or form of organization.'

"By these limitations the committee believes that it has removed the danger that taxable sales can be cast into the form of a reorganization, while at the same time, legitimate reorganizations, required in order to strengthen the financial condition of the corporation will be permitted. *Furthermore, the retention of the other reorganization provisions will prevent large losses from being established by bondholders* and stockholders *who receive securities in a newly reorganized enterprise which are substantially the same as their original investments.*

"Your committee is in complete agreement with the purposes of the House bill which aim at tax-avoidance schemes in this connection. However, some modifications are recommended in order to bring about a more uniform application of the provisions in all 48 of the States. Not all of the States have adopted statutes providing for mergers or consolidations; and, moreover, a corporation of one State can not ordinarily merge with a corporation of another State. The committee believes that it is desirable to permit reorganizations in such cases, with restrictions designed to prevent tax avoidance. Consequently, the committee recommends the insertion in the House bill

of an addition to the definition of the term 'reorganization' as follows:

"'(*B*) the acquisition by one corporation in exchange solely for its voting stock: of at least 80 per centum of the voting stock and at least 80 per centum of the total number of shares of all other classes of stock of another corporation; or of substantially all the properties of another corporation;'

"The committee believes that these transactions, when carried out as prescribed in this amendment, are in themselves sufficiently similar to mergers and consolidations as to be entitled to similar treatment. It will be noted that the proposed amendment requires that (1) the acquiring corporation must obtain at least 80 per cent of the voting stock and at least 80 per cent of the total number of shares of all other classes of stock of the other corporation. Instead of only a majority as provided by the present law; and (2) the acquisition, whether of stock or of substantially all the properties, must be in exchange solely for the voting stock of the acquiring corporation.

"Your committee approves the retention of the exchange and reorganization provisions with these changes. *Reorganizations are now being consummated in the majority of cases* to reduce the capital structure, and *to strengthen the financial condition of the participating corporations. If the reorganization provisions were omitted from the bill, many* stockholders and *bondholders could take large losses*, although they might retain substantially their former interests in the enterprise. Hence, the Treasury

has little or nothing to gain by the elimination of these provisions, while, on the other hand, some legitimate and desirable business readjustments would be prevented." (Italics supplied.)

The Conference Committee Report said (C. B. 1939-1, Part 2, page 632):

"Amendments Nos. 49, 50, 51, and 52: *These amendments broaden the scope of a reorganization* (as defined in the House bill) in connection with which exchanges of property may be made without the recognition of gain or loss. The amendments, in addition to making it clear that mergers and consolidations, as those terms are used in the reorganization definition, are confined to statutory mergers and consolidations, add to the definition of reorganizations the acquisition by one corporation for all or part of its voting stock of (1) 80 per cent of the voting stock and at least 80 per cent of the total number of shares of all other classes of stock of another corporation, *or* (2) *substantially all the properties of another corporation.* To conform to this addition, the definition of 'a party to a reorganization' is extended to include both corporations in the type of cases just mentioned. The House recedes." (Italics supplied ours.)

In response to the recommendation of a subcommittee of the Ways and Means Committee that the reorganization provisions be eliminated the Acting Secretary of the Treasury submitted a statement reading in part as fol-

lows: (Report of subcommittee of Ways and Means Committee, 73rd Cong. 2nd Sess., p. 9)

"In the second place, reorganizations today are generally being carried out in order to revise the capital structures of unsuccessful or insolvent enterprises. The immediate result of abolishing the reorganization provisions would be to permit the thousands of bondholders and stockholders of such organizations to establish losses, even though they obtain and retain securities in a new enterprise which is substantially the same as their original investment. Even though it be required that such losses can only be deducted from capital gains, a wide door will be opened to reduction of tax liability."